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Report to the Commissioner of Internal Revenue

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TAX ADMINISTRATION

The Federal/State Tax Information Exchange Program

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United States
General Accounting Office
Washington, D.C. 20548

General Government Division
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December 13, 1985

The Honorable Roscoe L. Egger, Jr.
Commissioner of Internal Revenue
Department of the Treasury

Dear Mr. Egger:

This report discusses the results of our review of the Federal/State Tax Information Exchange Program. Under this program, the Internal Revenue Service (IRS) and the states exchange tax information for purposes such as increasing tax revenues, reducing duplicate audits, and identifying noncompliant taxpayers. We made this review to assess how well IRS and the states use this program in their efforts to increase the level of voluntary compliance with the tax laws.

Our review showed that (1) IRS and the states were using some but not all of the tax data that they were exchanging and (2) IRS could do more to enhance overall program effectiveness by inventorying state data files, working with the states to automate tax records, and providing more program oversight. IRS program officials currently have efforts underway to improve the usefulness of the exchange program to both IRS and the participating states.

How the Federal/State Tax Information Exchange Program Works

IRS and the states have been exchanging tax data since the 1920s. Under section 6103(d) of the Internal Revenue Code, federal tax returns and return information are available to states for the purpose of tax administration, which includes increasing taxpayer compliance and related tax revenues. State laws also allow IRS access to state tax information for the same purpose.

Two formal agreements, known as the basic agreement and the implementing agreement, between IRS and the states govern the way data is exchanged and the types of tax data exchanged. The basic agreement is uniform for all states and contains general procedures for exchanging and safeguarding tax data. Modifications to the basic agreement must be approved by the Commissioner. The implementing agreement for each state tax agency supplements the basic agreement by specifying exchange instructions on who may request tax information; the items to be routinely exchanged, including criteria for selecting those items; and the format of the items exchanged. IRS officials said that they currently have basic agreements with 93 tax agencies in 49 states and the District of Columbia.

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IRS' Disclosure and Security Division is responsible for the overall operation of the exchange program. One IRS district office in each state is designated to coordinate the data exchanged between the state tax agencies and the various IRS offices located in the state. The IRS district disclosure officer in the designated district office is responsible for managing the exchange activities in that state. IRS relies on these district disclosure officers to assure that the states are properly using the federal tax data they receive.

States receive a variety of federal tax information from IRS offices, including revenue agent reports from district offices on audit adjustments made to federal tax returns; underreporter cases from service centers on taxpayers who did not report all of their income from wages, interest, or dividends; and computer tapes, such as extracts of IRS' individual and business master files from the national office. In 1984, IRS sent 86 million computer tape extract records and 2.9 million other federal taxpayer documents to the states. IRS also received varied state tax information, such as state audit reports and tax protestor referrals. Information on the number of state tax documents forwarded to IRS was not readily available.

Objective, Scope, and Methodology

Our overall objective was to evaluate how well the Federal/State Tax Information Exchange Program was working.

To achieve this objective, we inquired into:

- what use IRS was making of state tax data;
- whether states were using all of the federal tax data they received;
- what other state tax data, if any, was available for IRS use; and
- whether program effectiveness could be enhanced through improved program management and better use of automation.

We did our work at the IRS national office, 4 regional offices, 22 district offices, 8 service centers, and 16 tax agencies in 15 states and the District of Columbia (see app. I). We visited these various state tax agencies and IRS district offices and service centers to obtain first-hand knowledge of how the exchange program operates at different locations. These visits also allowed us to identify whether any states' tax administration activities were unique and to review IRS' decentralized approach to managing the exchange program.

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In performing our work we (1) analyzed IRS policies, procedures, internal studies, and instructions related to the exchange program; (2) interviewed IRS disclosure officers and compliance officials about the uses made of state tax data and the benefits gained from using state data; (3) interviewed state tax agency officials about their use of federal tax data and the relevancy of state tax data for federal tax administration purposes; and (4) analyzed samples of the federal and state data being exchanged. Our methodology is more fully discussed in the respective sections of this report. We made our review during the period of July 1983 to August 1984 in accordance with generally accepted government audit standards.

About the time we began our detailed work on the exchange program, both IRS and the National Association of Tax Administrators (NATA), which is a research and legislative organization representing state tax administrators, initiated separate studies of the exchange program. IRS set up a task force to study how it could make better use of state tax data, while NATA studied the usefulness of the federal tax data that states receive from IRS. Before IRS and NATA began their studies, we briefed them on our observations of the program. We then coordinated our effort with IRS and NATA so that our work would supplement, rather than duplicate, their studies.

IRS' Use of State Tax Data

In order to gain perspective on IRS' use of state tax data and identify what problems, if any, IRS was experiencing with the exchange program, we obtained a random sample of 958 individual income tax adjustments which were sent to IRS by four states—California, New York, North Carolina, and South Carolina. We had the states provide us with this sample because IRS does not keep readily available records on all the audit adjustments it receives from the states. Although the results of this sample of 958 adjustments are not projectable, we believe they provide some insight into how IRS is using the state data it receives.

Tax agencies in these four states sent these adjustments to IRS in 1982. We used calendar year 1982 adjustments because IRS said that it would have had sufficient time to review and use these adjustments. We limited our review of IRS' use of state tax data to these four states because (1) they routinely provide IRS with their audit adjustments and (2) they were able to readily provide us with copies of the tax data sent to IRS, thereby expediting our case analysis.

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After receiving these 958 adjustments, we asked IRS to determine for us whether additional federal taxes were assessed on the taxpayer based on the state audit adjustments, and, if not, why the state data was not used. As shown in Table 1, in 213, or about 22 percent, of the 958 cases, IRS either assessed additional federal taxes or was working on the cases when we completed our detailed work in August 1984. IRS could not or did not use the remaining 745 cases, or 78 percent, for the reasons cited in Table 1.

Table 1: IRS' Use of State Tax Data

	Number of cases	Percent of total
IRS used state data		
Federal tax assessed	96	10.0
Case being worked on at the time of our review	117	12.2
Subtotals	**213**	**22.2**
IRS did not use state data		
IRS had previously audited the case	65	6.8
Taxpayer had filed an amended federal tax return	61	6.4
Case had little or no potential for additional federal taxes	175	18.2
Statute of limitations was pending or had expired[a]	110	11.5
Resource constraints prevented IRS use of data	24	2.5
State documentation was incomplete	16	1.7
IRS could not determine by its records why case was not used	269	28.1
Other	25	2.6
Subtotals	**745**	**77.8**
Totals	**958**	**100.0**

[a]Section 6501 of the Internal Revenue Code generally gives IRS 3 years from the date a return is filed or the return due date, whichever is later, to assess a taxpayer additional tax.

Exchanging unused tax data benefits no one, and the handling of the confidential data increases the risk of unauthorized disclosure and creates unnecessary administrative costs. IRS officials recognize this; however, they were not aware of the extent to which they were not using the data received or of the reasons for nonuse. Thus, they were not in a good position to identify problems or the corrective actions needed to resolve them.

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States' Use of Federal Tax Data

In order to gain perspective on the states' use of federal data and identify what problems, if any, the states were experiencing with the exchange program, we randomly sampled 2,648 of the 631,667 individual income tax adjustment cases for which IRS provided the following seven states with paper documentation in calendar year 1982—Arizona, California, Massachusetts, Maryland, Michigan, North Carolina, and New York. The results of the sample discussed above are projectable to the seven-state universe with a sampling error of plus or minus 3 percent at a 95 percent confidence level. We used calendar year 1982 disclosures because the states, as IRS, would have had sufficient time to review and work the sample cases. We selected these seven states because they represent a good cross section (size, geographic location, etc.) for gaining insight into how states were using the federal tax data.

As shown in Table 2, in 1,260, or about 48 percent, of the 2,648 sample cases, the states either assessed additional taxes or were working on the cases when we completed our review work. The remaining 1,388 cases, or 52 percent, were not worked on for the reasons cited in Table 2.

Table 2: States' Use of Federal Individual Income Tax Adjustments

	Number of cases	Percent of total
States used IRS' audit adjustments		
State tax assessed	1,216	45.9
Case being worked on at the time of our review	44	1.7
Subtotals	**1,260**	**47.6**
States did not use IRS' audit adjustments		
Taxpayer had filed an amended state tax return	119	4.5
Resource constraints prevented state from using data	157	5.9
Case had little or no potential for additional state taxes	193	7.3
Information on why the states did not use the case was not readily available at the time of our review[a]	919	34.7
Subtotals	**1,388**	**52.4**
Totals	**2,648**	**100.0**

[a]While state records did not readily explain why these cases were not used, the Executive Director, NATA, suggested that reasons might have included the following: (1) the taxpayer moved out of the state, (2) the taxpayer had no state filing requirement, and (3) the taxpayer's name and social security number did not agree with state records.

At the time we did our work, the Internal Revenue Manual stated that disclosure officers were to periodically review states' use of federal tax data to ensure that the states receive only that data which they need and can use. However, there was no firm requirement as to when these

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reviews were to be made. Disclosure officers could use their own discretion to determine the frequency of reviews. However, in six of the seven states where we sampled the states' use of federal tax adjustments, disclosure officers had not conducted periodic usage reviews. As previously discussed, unused tax data benefits no one, increases the risk of unauthorized disclosure, and creates unnecessary administrative costs.

IRS Inventory of State Data Files

To take full advantage of state data, IRS first needs to know what data the states have which can be used in its compliance programs. However, at the time of our review, IRS had not systematically inventoried state tax agencies' data files to identify the information available and assess its usefulness. Such a compilation is necessary for determining if state data can be effectively used and incorporated into IRS' compliance programs.

During our review, we found that the 16 tax agencies we visited generally have two types of information with potential usefulness to IRS: (1) state audit results which could affect the taxpayers' federal tax liability and (2) various data files which contain taxpayer information that could aid IRS in its compliance activities. For example:

- One state we visited has a sizable independent audit program (about 10,000 adjustments in 1983) which addressed some issues that had potential federal implications, such as itemized deductions for individual income taxpayers. At the time of our review, the state was not sending its audit reports to IRS.
- Another state we visited has a computerized data file on homeowners which includes about 7,000,000 taxpayer names and social security numbers. The state uses this file to identify individuals who erroneously claim renter's credits on their state income tax returns for homes they occupy as owners rather than renters. IRS could potentially use this file to detect individuals who erroneously deduct real property taxes and mortgage interest on their federal tax returns.

Further, we developed an inventory of some of the data files and compliance programs that were available at the 16 tax agencies we visited. The tax agencies identified 167 data files that they were using in their compliance activities. We believe that some of these files could also be useful to IRS in its compliance activities.

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Compatible Computerized Data

During our review we noted that increased automation of tax records in a format compatible to both IRS and the states could possibly enhance program effectiveness. For example, the federal taxpayer identification numbers are the key reference point IRS uses for matching the various taxpayer records used in its compliance programs—social security numbers for individual taxpayers and employer identification numbers for businesses. As previously discussed, we visited 15 state tax agencies and the District of Columbia. Of the 16 locations visited, 1 did not use the social security number on some of its individual income tax records, 5 did not use the employer identification number on some of their corporate income tax records, and 7 agencies did not use the employer identification number on some of their sales tax records. Also, in the 16 tax agencies visited, we found few instances of completely computerized state records outside the individual income tax area.

We recognize that it may not be practical for all state tax agencies to automate their tax records in a format that is compatible with IRS. Even so, we believe that IRS can work with the states to identify opportunities where data conversion and automation is possible and cost-effective. We also believe that more compatible automated tax records would benefit both IRS and the states. Such records would enable IRS to more effectively process state data while at the same time provide an opportunity for the states to use more federal data and use it more efficiently.

Exchange Program Oversight

Another way to improve the program is through increased program oversight by IRS' Disclosure and Security Division. Officials in this division recognize that greater program oversight would better identify systemic as well as local problems associated with the exchange program. They also recognize that because of shortcomings in the exchange activity monitoring process, IRS has not been in a very good position to know how well the program is operating in each district or nationwide. In essence, IRS does not have all the information it needs to assure that an effective networking system exists between the district offices and the state tax agencies.

IRS officials recognize that without sufficient communication avenues, they cannot continually identify where the program can be improved or assess overall program operations. They said that current changes underway should improve the situation. They also agreed that greater oversight would be beneficial. However, greater program oversight to identify program operations needing improvement will be dependent on the amount of resources IRS is able to direct to this monitoring function.

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IRS Recognizes the Need for Program Improvements and Is Taking or Plans to Take Corrective Action

As previously mentioned, IRS formed a task force to study the exchange program. The study was conducted, in part, because IRS felt a need to reassess the benefits of state data in light of the growing levels of noncompliance and budgetary constraints. Other factors that entered into IRS' decision to review the exchange program included comments it received from the states on the usefulness of state data and comments it received from us on ways to improve the program.

The task force's findings on IRS' use of state data corresponded with the ones previously discussed in this report, and IRS is taking or plans to take action to address them. For example, IRS intends to

- complete a study by December 31, 1985, on the value of state data as a source of leads to federal nonfilers;
- initiate by December 31, 1985, the screening and processing of state data at its service centers instead of at the district offices;
- design by December 31, 1987, a system to monitor a sample of state cases to determine its use and nonuse of state data; and
- explore by December 31, 1987, various options to overcome the barriers of using state data placed on IRS by the 3-year statute of limitations.

IRS is also currently working with the states in compiling an inventory of state tax data files and plans to have potential IRS users analyze and test the usefulness of the data for actual use in their compliance programs. IRS is also discussing the merits of compatible computerized data with the various state tax agencies to see if data conversion and automation is possible and cost-effective.

In addition to the improvements being made in IRS' use of state tax data, IRS has also taken action in the area of states' use of federal data. In September 1984, IRS revised its manual instructions to require disclosure officers to do annual on-site usage reviews of states' use of federal tax data. IRS' Disclosure and Security Division officials plan to monitor the results of these usage reviews to see if they are being properly conducted and to minimize the amount of federal data sent to but not used by the states. These IRS officials believe that the required usage reviews, coupled with more program oversight, will enhance the overall data exchange process.

We believe these initiatives will enhance overall program effectiveness, especially with regard to IRS' use of state tax data. For example, if IRS had previously established a system to more effectively monitor its use and nonuse of state data, it could have better identified why certain

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state adjustments were not being used and the extent of the statute of limitations problem. As noted on page 4, these areas accounted for over 50 percent of the unused cases in our sample (110 + 269 divided by 745 equals 50.9 percent).

In its May 1984 strategic operating plan, IRS further recognized the need to work more closely with state governments in administering tax enforcement programs. The plan states that IRS has tended to rely too much on its own compliance initiatives to identify and solve tax administration problems and that it had not made maximum use of other available resources. Specifically, the plan laid out two initiatives for working with the states which IRS believes will aid in detecting noncompliance. One initiative is to develop additional sources of information to detect noncompliance through cooperative programs with the states. This initiative is directed toward establishing joint compliance projects and dividing the audit workload between IRS and those states which have examination programs.

The second IRS initiative deals with pursuing, in cooperation with NATA, the enactment of state statutes which will enhance both federal and state tax administration. Under this initiative, IRS will pursue in cooperation with NATA the enactment of legislation that would require any persons providing goods or services to the states, or applying to the states for a license to do business, to certify under penalty of perjury that they have filed all tax returns and paid any tax required by the state. The purpose of this initiative is to surface delinquent taxpayers or nonfilers by matching the certifications with the state income tax records. The state tax records could then be exchanged with IRS to determine whether these individuals are complying with federal tax laws.

To the extent these two initiatives are successful, they should improve the federal/state relationship and enhance overall exchange program operations.

NATA's Initiatives to Improve the Program

NATA has been instrumental in improving the exchange program by sponsoring joint taxpayer compliance workshops with IRS and state tax agency officials. These workshops are an additional vehicle for both the states and IRS to learn more about each other's data needs. NATA held two of these workshops in 1985—computer application programming in tax administration and collection of delinquent taxes.

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As previously mentioned, NATA has also studied the exchange program. For example, in June 1983, NATA sent questionnaires to tax agencies in 50 states and the District of Columbia to determine the uses and value of the federal data they receive. On the basis of its results, NATA concluded that the exchange program remains a vital part of the states' tax enforcement efforts and meets the basic needs of the states. NATA also noted, however, that the states varied significantly in their use of some federal data, and that it could not readily determine why some states were using certain IRS data and others were not.

NATA believes that the differences may be due to the states having limited knowledge of the full availability of IRS information and a limited knowledge of how other states use the data. NATA concluded that if states knew more about each other's practices, there would be a narrowing of the differences and increased conformity in use. Also, NATA officials told us that if IRS audit reports were on magnetic media, some states could make more effective use of this data. According to NATA and IRS officials, IRS and NATA will continue to work together to help the states become better informed about the availability and applicability of IRS data.

Conclusions

The Federal/State Tax Exchange Program has been beneficial to both IRS and participating states in their efforts to promote taxpayer compliance and increase tax revenues. There are opportunities, however, for state and federal tax administrators to refine and streamline the existing data exchange process and identify and develop additional exchangeable data needed in federal and/or state compliance programs. By effectively coordinating their efforts, federal and state tax administrators can promote overall compliance and enforce taxes more efficiently and economically.

IRS has recently taken or plans to take specific actions to improve program operations, especially with regard to making better use of state tax data. Also, IRS has taken action to reduce the amount of federal data that is being sent to but not used by the states and has acknowledged the need for more program oversight. NATA has and continues to serve as a communication link between IRS and the states to foster improvements in the exchange program.

We recognize that these efforts on the part of IRS, NATA, and the states will take time, energy, and communication. But, we also believe that this investment will enhance the exchange process as a compliance tool and

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benefit both parties. Because specific initiatives are being undertaken by IRS to address the issues discussed in this report, we are not making any recommendations.

We provided a draft of this report to IRS and NATA officials for their review and oral comments. They generally agreed with the information presented in this report and their views were considered in preparing the final report. We are sending copies of this report to the tax agencies included in our review and the tax agencies in the remaining states. We will also make copies available to other interested parties.

We sincerely appreciate the courtesy and cooperation extended to us by your headquarters, regional, district, and service center staff.

Sincerely yours,

W. J. Anderson

William J. Anderson
Director

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Appendix I

Fieldwork Locations

In addition to IRS' national office in Washington, D.C., we did our work at the following locations:

IRS Regional Offices	IRS District Offices	IRS Service Centers	Tax Agencies
Atlanta, GA	Albany, NY	Andover, MA	Arizona
New York, NY	Atlanta, GA	Atlanta, GA	California
Philadelphia, PA	Baltimore, MD	Brookhaven, NY	Colorado
San Francisco, CA	Boston, MA	Cincinnati, OH	Georgia
	Brooklyn, NY	Fresno, CA	Illinois
	Chicago, IL	Memphis, TN	Massachusetts
	Cincinnati, OH	Ogden, UT	Maryland
	Cleveland, OH	Philadelphia, PA	Michigan
	Columbia, SC		New Jersey
	Denver, CO		New York
	Detroit, MI		North Carolina
	Greensboro, NC		Ohio
	Los Angeles, CA		South Carolina
	New York, NY (Manhattan)		Utah
	Newark, NJ		Virginia
	Philadelphia, PA		Washington, DC
	Phoenix, AZ		
	Portland, OR		
	Richmond, VA		
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